THE WALL STREET JOURNAL

IRS Checks Virtues of Charity

Do Donor-Advised Funds Also Benefit the Donor?

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January 20, 2007; Page B2

The IRS is putting donor-advised funds under the microscope.

These funds, which have grown increasingly popular over the past few years, allow an individual to make a donation, receive an immediate tax deduction and then later "advise" which charities receive distributions. In 2005, donor-advised funds distributed more than $3 billion to charities, according to the Chronicle of Philanthropy.

A donor-advised fund can hold cash, securities, mutual funds and even real estate, depending on the rules of the entity, or "sponsoring organization," that administers it.

Now the Internal Revenue Service is scrutinizing them, prompted by various worries, including the possibility that some donors have used the products as tax-free slush funds.

The Pension Protection Act, passed in August, imposes fines and penalties for donors who use donor-advised funds to benefit themselves, their families or their financial advisers. The law also directed the IRS to study donor-advised funds over the next year and look at whether further rules are needed to prevent abuse.

Some worry, however, that the new rules are discouraging donors.

"We have been concerned about the area of donor-advised funds for some time," says Steven T. Miller, commissioner of the IRS Tax Exempt and Government Entities Division. "We are now working to implement the many changes made to this area as part of the Pension Protection Act. ... We have an active examination program on donor-advised funds, and we continue to work on the study requested by Congress."

Behind the scrutiny is the concern "that people are using donor-advised funds for personal expenses like tickets or tuition," says Charles B. Gordy, managing director and senior planned-giving officer at **Bank of New York** Co.

One possible abuse might involve a private school waiving tuition payments for the child of a donor who advised a gift to the school, says Victoria B. Bjorklund, a partner and head of the exempt organizations group at Simpson Thacher & Bartlett, a New York law firm.

"That was improper in the previous situation, but the law clarifies that it is improper and that a penalty applies," says Ms. Bjorklund. She says she believes the new pension law is good news for donor-advised funds because it clarifies the rules by which Congress expects them to operate.

Well-run donor-advised funds have had to make very few changes in their operations in response to the law, says Ms. Bjorklund.

Donor-advised funds have been around for decades but surged in popularity in the 1990s after Fidelity Investments, Vanguard Group, **Charles Schwab** Corp. and other financial-services companies introduced their own versions. Recently, some funds have lowered their minimum initial contributions to $5,000 or even less.

The Fidelity Charitable Gift Fund, which managed $4.1 billion at the end of 2006, distributed $954 million to charity last year. It also saw a surge of new accounts over that time: The fund opened at least 4,700 new accounts in 2006, compared with 2,641 new accounts in 2005, according to Fidelity.

After the initial contribution to a donor-advised fund is made, a donor theoretically gives up control over distributions because the sponsoring organization legally owns the assets. A donor may advise, suggest or recommend grants made by the fund over time, but the donor isn't technically allowed to direct gifts.

Most of the time, recommendations are honored, however, if they are legitimate, says Eileen R. Heisman, president and chief executive of the National Philanthropic Trust in Jenkintown, Pa.

The Pension Protection Act essentially took a group of financial instruments that had been unregulated for decades and made them a "very highly regulated area," says Bruce Makous, vice president for development at the Multiple Sclerosis Association of America in Cherry Hill, N.J., and president of the Planned Giving Council of Greater Philadelphia.

Mr. Makous has been a critic of certain aspects of donor-advised funds, charging that charities sometimes give kickbacks to the sponsoring organizations. For example, a sponsoring organization that directs a gift to a certain charity might be rewarded by being allowed to manage the money for the charity, he says.

Joan Crain, senior director of wealth-management strategies at **Mellon Financial** Corp., says she believes that, because the funds are being scrutinized, "the advantages donor-advised funds have over private foundations are being eroded."

Those advantages, she says, include bigger tax deductions and greater freedom in gift-giving. A private foundation must make at least a minimum distribution each year, in contrast to a donor-advised fund, which doesn't have to give anything away in a given year, she says. (Mellon doesn't sponsor a donor-advised fund but has talked to some commercial organizations about referring business to them, according to Ms. Crain.)

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